56099

55pp

No. 06-1509

In the Supreme Court of the United States

MICHAEL H. BOULWARE, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

PAUL D. CLEMENT
Solicitor General
Counsel of Record

RICHARD T. MORRISON
Acting Assistant Attorney General

MICHAEL R. DREEBEN
Deputy Solicitor General

DEANNE E. MAYNARD
Assistant to the Solicitor General

ALAN HECHTKOPF
KAREN QUESNEL
S. ROBERT LYONS
Attorneys

Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

QUESTION PRESENTED

Whether the diversion of corporate funds to a shareholder of a corporation without earnings and profits automatically qualifies as a nontaxable return of capital up to the shareholder's stock basis, see 26 U.S.C. 301(c)(2), even if the diversion was not intended as a return of capital.

TABLE OF CONTENTS

Page

Opinions below 1
Jurisdiction 1
Statutory provisions involved 2
Statement 2
Summary of argument 10
Argument 13
The diversion of corporate funds to a shareholder of a corporation without earnings and profits does not automatically qualify as a nontaxable return of capital up to the shareholder's stock basis 13
A. The text of Section 301(a) requires evidence that the payments were in fact distributions to the taxpayer by reason of his status as a shareholder 14
B. Congressional purpose would be thwarted if unexplained diverted funds were automatically treated as distributions with respect to stock 22
C. The approach of the court below is consistent with civil tax cases 24
D. The approach of the court below does not shift the burden of proof 31
E. Petitioner's convictions should be affirmed even if a lack of earnings and profits, and a sufficient stock basis, are the only elements of a return-of-capital defense 34
Conclusion 38

TABLE OF AUTHORITIES

Cases:

AJF Transp. Consultants, Inc. v. *Commissioner*, 77 T.C.M. (CCH) 1244 (1999), aff'd, 213 F.3d 625 (2d Cir. 2000) 28

Cases—Continued: Page

Commissioner v. *Court Holding, Co.*, 324 U.S. 331 (1945) 31
Commissioner v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955) 22
Commissioner v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974) 31
Commissioner v. *Tufts*, 461 U.S. 300 (1983) 20
Crane v. *Commissioner*, 331 U.S. 1 (1947) 15
Crowley v. *Commissioner*, 962 F.2d 1077 (1st Cir. 1992) 20
Diedrich v. *Commissioner*, 457 U.S. 191 (1982) 31
DiLeo v. *Commissioner*, 96 T.C. 858 (1991), aff'd, 959 F.2d 16 (2d Cir.), cert. denied, 506 U.S. 868 (1992) 28
DiZenzo v. *Commissioner*:
348 F.2d 122 (2d Cir. 1965) 27, 28, 34, 35
23 T.C.M. (CCH) 677 (1964), rev'd in part, 348 F.2d 122 (2d Cr. 1965) 28
Drybrough v. *Commissioner*, 238 F.2d 735 (6th Cir. 1956) 36
Elliotts, Inc. v. *Commissioner*, 716 F.2d 1241 (9th Cir. 1983) 20
Hartford Underwriters Ins. Co. v. *Union Planters Bank, N.A.*, 530 U.S. 1 (2000) 15
Holland v. *United States*, 348 U.S. 121 (1954) 32, 33
James v. *United States*, 366 U.S. 213 (1961) .. 3, 20, 22
Magnon v. *Commissioner*, 73 T.C. 980 (1980) 30
Neder v. *United States*, 527 U.S. 1 (1999) 3

Cases–Continued: Page

Neonatology Assocs., P.A. v. *Commissioner*, 299 F.3d 221 (3d Cir. 2002) 28, 29
Noble v. *Commissioner*, 368 F.2d 439 (9th Cir. 1966) 29, 30
Old Colony Trust Co. v. *Commissioner*, 279 U.S. 716 (1929) 31
Rutkin v. *United States*, 343 U.S. 130 (1952) 3, 22
Sansone v. *United States*, 380 U.S. 343 (1965) 4
Spies v. *United States*, 317 U.S. 492 (1943) 22
Truesdell v. *Commissioner*, 89 T.C. 1280 (1987), action on decision, 1988-25, 1988 WL 570761 (Sept. 12, 1988), *acq.*, 1988-2 C.B. 1 (1988) .. 25, 26, 27, 34, 36
United States v. *Bishop*, 412 U.S. 346 (1973) 3
United States v. *Bok*, 156 F.3d 157 (2d Cir. 1998) 10, 24, 31, 34
United States v. *D'Agostino*, 145 F.3d 69 (2d Cir. 1998) ..... *passim*
United States v. *Leonard*, 524 F.2d 1076 (2d Cir. 1975), cert. denied, 425 U.S. 958 (1976) .. 27, 31, 32, 33
United States v. *Massei*, 355 U.S. 595 (1958) 32
United States v. *Miller*, 545 F.2d 1204 (9th Cir. 1976), cert. denied, 430 U.S. 930 (1977) ..... *passim*
United States v. *Pomponio*, 429 U.S. 10 (1976) 20

Statutes and regulations:

18 U.S.C. 371 2
26 U.S.C. 1 (2000 & Supp. V 2005) 2
26 U.S.C. 61(a) 3

Statutes and regulations--Continued: Page

26 U.S.C. 115 (1946) 28
26 U.S.C. 1621(a)(1) 20
26 U.S.C. 165(e) 20
26 U.S.C. 301 ..... *passim*
26 U.S.C. 301(a) ..... *passim*
26 U.S.C. 301(c) 4, 11, 15, 17, 28
26 U.S.C. 301(c)(2) 6, 14, 15
26 U.S.C. 316 ..... 4, 21, 22
26 U.S.C. 316(a)(2) 4, 21
26 U.S.C. 6012(a)(1)(A) 3
26 U.S.C. 6151(a) 2, 3
26 U.S.C. 7201 ..... 2, 3
26 U.S.C. 7206(1) 2, 3
28 U.S.C. 1254(1) .....
26 C.F.R. 1.301-1(c):
(2007) 16, 17, 19
(1955) 16
26 C.F.R. 1.162-1(a) 20

Miscellaneous:

Oxford American Dictionary and Language Guide (1999) 16
Random House Dictionary of the English Language (2d ed. 1987) 16
S. Rep. No. 1622, 83d Cong., 2d Sess. (1954) 16
Webster's New International Dictionary of the English Language (2d ed. 1957) 16

Miscellaneous—Continued: Page

Webster's Third New International Dictionary of the English Language (1993) 16

In the Supreme Court of the United States

No. 06-1509

MICHAEL H. BOULWARE, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinions of the court of appeals (Pet. App. 1-14, 27-62) are reported at 470 F.3d 931 and 384 F.3d 794, respectively.

JURISDICTION

The judgment of the court of appeals was entered on December 13, 2006. A petition for rehearing was denied on April 23, 2007 (Pet. App. 63). The petition for a writ of certiorari was filed on May 11, 2007. The petition was granted on September 25, 2007. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant statutory provisions are set forth in an appendix to this brief. App., *infra*, 1a-10a.

STATEMENT

Following a jury trial in the United States District Court for the District of Hawaii, petitioner was convicted on five counts of willfully filing false tax returns, in violation of 26 U.S.C. 7206(1); four counts of willfully attempting to evade tax, in violation of 26 U.S.C. 7201; and one count of conspiring to make a false statement to a federally insured financial institution, in violation of 18 U.S.C. 371. The court of appeals, in a prior appeal, affirmed the conspiracy conviction but reversed the tax convictions and remanded for a new trial. Pet. App. 27-62. This Court denied a petition for a writ of certiorari. 546 U.S. 814 (2005).

On remand, petitioner was again found guilty by a jury on the tax counts, and he was sentenced to 36 months of imprisonment on the false return counts and 60 months of imprisonment on the tax evasion and conspiracy counts, to run concurrently. Pet. App. 2-3. On a second appeal, the court of appeals affirmed both the convictions and the sentence. *Id.* at 1-14.

1. a. The requirement to pay taxes is set forth in Section 1 of the Internal Revenue Code (Code), which imposes a tax on the taxable income of individuals, estates, and trusts as determined by the tables set forth in that section. 26 U.S.C. 1 (2000 & Supp. V 2005). Under Section 6151(a) of the Code, "when a return of tax is required under this title or regulations, the person required to make such return shall, without assessment or notice and demand from the Secretary, * * * pay such tax at the time and place fixed for filing the return." 26

U.S.C. 6151(a). "Every individual having for the taxable year gross income which equals or exceeds" a statutorily determined amount is obligated to file a tax return. 26 U.S.C. 6012(a)(1)(A).

Under Section 61(a) of the Code, "gross income means all income from whatever source derived." 26 U.S.C. 61(a). That includes lawful and unlawful gains, regardless of whether the taxpayer has any legal right to retain the money. *James* v. *United States*, 366 U.S. 213, 219 (1961) (plurality opinion); *Rutkin* v. *United States*, 343 U.S. 130, 136-137 (1952).

b. Under Section 7206(1) of the Code, anyone who "[w]illfully makes and subscribes any return * * * which contains * * * a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter" commits a felony punishable by a fine not more than $100,000, or imprisonment of not more than three years, or both, together with the costs of prosecution. 26 U.S.C. 7206(1). To obtain a conviction for filing false returns, the government must establish that the defendant willfully made and subscribed under penalty of perjury income tax returns that he did not believe to be true and correct as to every material matter. See *Neder* v. *United States*, 527 U.S. 1, 16 (1999); *United States* v. *Bishop*, 412 U.S. 346, 350 (1973).

Under Section 7201 of the Code, anyone who "willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof commits a felony" punishable by a fine of not more than $100,000 or imprisonment of not more than five years, or both, together with the costs of prosecution. 26 U.S.C. 7201. To support a conviction for income tax evasion, the government must prove the existence of a tax deficiency, an

affirmative act of attempted evasion of tax, and willfulness. See *Sansone* v. *United States*, 380 U.S. 343, 351 (1965).

c. Section 301(a) of the Code provides that a distribution of property "made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)." 26 U.S.C. 301(a). Section 301(c) divides distributions made with respect to stock into three categories: (1) the portion that is a dividend (as defined by 26 U.S.C. 316) is taxable as ordinary income; (2) any portion that is not a dividend is treated as a return of capital up to the amount of the shareholder's basis in his stock and is nontaxable, but is "applied against and reduce[s]" the shareholder's "adjusted basis of the stock"; and (3) any amount in excess of the shareholder's basis is taxable as a capital gain. 26 U.S.C. 301(c).

Section 316 in turn defines a "dividend" as a distribution of property by a corporation to its shareholders "out of its earnings and profits." 26 U.S.C. 316(a)(2). Section 316(a) further provides, with exceptions not pertinent here, that "every distribution is made out of earnings and profits to the extent thereof." 26 U.S.C. 316(a). Read together, Section 301 and Section 316 establish that, if a corporation makes a distribution of funds to its shareholders "with respect to its stock," the tax consequences of the distribution depend, in part, on whether the corporation has earnings and profits and the amount of the shareholder's adjusted stock basis.

2. Petitioner is the founder, former president, and 50% owner of a closely held corporation, Hawaiian Isles Enterprises (HIE), that deals in tobacco distribution, coffee processing and sales, arcade games, vending machines, and bottled water. Pet. App. 2. A trust for the

benefit of petitioner's son owns the other 50% of HIE stock. J.A. 82-83, 86-88, 133. Following a six-year investigation, the Internal Revenue Service (IRS) determined that, during the period from 1989 to 1997, petitioner had diverted more than $10 million from HIE and failed to report those funds on his personal income tax returns and to pay taxes on that income, and that he had used fraudulent invoices in applying for a bank loan. The scheme to divert money from HIE involved a variety of devices. Petitioner diverted some of the funds by giving HIE checks to friends and employees and instructing them to cash the checks and then return the cash to petitioner. He diverted other funds by establishing two bank accounts in HIE's name but under petitioner's exclusive control, then depositing proceeds from HIE sales into the accounts without recording the sales on HIE's books. Petitioner also diverted HIE funds by instructing businesses that purchased coffee from HIE to remit payment directly to petitioner. In addition, petitioner used false invoices to obtain a loan from a federally insured financial institution. Pet. App. 2-3, 29-30; C.A. E.R. 334-339, 459-460, 466-467, 482, 486.

Petitioner laundered some of the diverted funds through companies in the Kingdom of Tonga and Hong Kong, and used the funds to support a lavish lifestyle, giving millions of dollars in HIE funds both to his wife and to his girlfriend. Pet. App. 2-3, 30-31; J.A. 15-17.

3. Petitioner was charged in a superseding indictment with nine counts of willfully filing false tax returns, four counts of willfully attempting to evade tax, four counts of making false statements to a federally insured financial institution, and one count of conspiracy to make such false statements. Pet. App. 29. The false return counts charged that the returns were false in that they

underreported petitioner's total income. J.A. 10-14.[1] Petitioner was convicted on five counts of filing a false tax return, four counts of tax evasion, and the conspiracy count. He was acquitted on the four counts of making false statements to a federally insured financial institution. Pet. App. 29.

4. The court of appeals affirmed petitioner's conviction on the conspiracy count, and it reversed his convictions on the tax counts and remanded for further proceedings. Pet. App. 27-62. The court reversed the tax convictions because it concluded that the district court had erred in excluding from evidence a state-court judgment that had determined, as between petitioner's girlfriend and HIE, that the funds petitioner delivered to his girlfriend belonged to HIE. *Id.* at 33-52.

The court of appeals rejected petitioner's challenge to the sufficiency of the evidence on the tax counts. Pet. App. 52-56. Petitioner contended that the government had failed to establish the existence of a tax deficiency. *Id.* at 52. He argued, *inter alia*, that the government had failed to prove that the corporate funds he diverted for his personal use did not constitute nontaxable returns of capital under 26 U.S.C. 301(c)(2). The court of appeals rejected that argument based on its decision in *United States* v. *Miller*, 545 F.2d 1204 (9th Cir. 1976), cert. denied, 430 U.S. 930 (1977), which held that the

---

[1] In response to petitioner's motion for severance, the district court required the government to elect between evasion and false-return charges, where the indictment charged both offenses for the same years (*i.e.*, 1994 through 1997). As reflected in the redacted indictment (J.A. 10-18), the government chose to proceed on the evasion counts. The false return counts for 1994 through 1997 were severed and were subsequently dismissed. Pet. App. 29 n.1.

government demonstrates a deficiency once it proves that the defendant received and failed to report unexplained corporate funds. Pet. App. 54. The court of appeals also rejected petitioner's argument that, even if the government had established its case, he had "met his burden of going forward with the evidence by testifying that the diversions were loans and were accounted for as such on HIE's books." *Id.* at 56. The court concluded that there was "ample evidence" from which a rational jury could determine that the diversions were not loans and that petitioner was guilty of tax evasion and willfully submitting false tax returns. *Ibid.*

5. On retrial of the tax charges, the government's theory of the case, as originally, was that petitioner had embezzled funds from HIE by diverting millions of dollars in corporate funds to his personal benefit, and that he had failed to report those funds as income on his individual tax returns. C.A. E.R. 815-820 (closing argument). In defense, petitioner alternatively claimed that the diverted funds were nontaxable "if they are considered to be corporate advances or loans," or "if [petitioner] used the monies for corporate purposes," J.A. 97, or if they were constructively treated as a return of capital. J.A. 97-98.

The district court granted the government's motion in limine to exclude evidence offered by petitioner to establish that the diverted funds should be treated as a constructive return of capital. Pet. App. 22; see *id.* at 16-19. At a hearing, the court concluded that the government, by adducing evidence of the receipt by petitioner of unexplained funds, had demonstrated that petitioner had unreported income. *Id.* at 17. The court held that, before petitioner could rely on a return-of-capital defense, petitioner had to make "some demonstration on

the part of the taxpayer and/or the corporation that such distributions were intended to be" a return of capital. *Ibid.* (quoting *Miller*, 545 F.2d at 1215). The court noted that HIE's comptroller "ha[d] testified that there were no returns of capital during the years in question." *Id.* at 18; J.A. 46; see Pet. App. 32.

Petitioner subsequently made an offer of proof, stating, *inter alia*, that he would present expert testimony that "as the controlling shareholder, the monies could be deemed a constructive dividend or return of capital to [petitioner] which may or may not be income depending on whether or not HIE had earnings and profits for the years when the monies were obtained by [petitioner]." J.A. 97-98. The district court concluded that this offer of proof was insufficient to lay the necessary foundation for a return-of-capital defense. Pet. App. 21-22. The court observed that "it is not relevant whether the funds could have been classified as a return of capital or a dividend at the time when they were diverted." *Id.* at 21. Rather, the defendant "must introduce evidence showing that, at the time of the transfer, the funds were in fact a return of capital." *Id.* at 21-22.

At the close of the retrial, the district court instructed the jury that funds acquired "either lawfully or unlawfully, without consensual recognition of an obligation to repay, and without restriction on their disposition" are income. J.A. 174. It informed the jury of petitioner's position that the funds he received were "corporate assets" of HIE and thus "not reportable income to him," J.A. 173, and petitioner's asserted belief that the funds "were accounted for as assets and/or property of the company, or as officer loans." J.A. 174. It further instructed the jury that "[a] loan is not income," and

described the attributes of a bona fide loan. J.A. 174-175; C.A. E.R. 852-853.

The jury found petitioner guilty on four counts of tax evasion and five counts of filing a false income tax return. The district court imposed a concurrent sentence of 36 months of imprisonment on the false return counts and 60 months of imprisonment on the tax evasion and conspiracy counts. Pet. App. 2-3.

6. The court of appeals affirmed. Pet. App. 1-14. The court of appeals held that the district court had correctly construed *Miller* as requiring evidence "not merely that the funds *could* have been a return of capital, but that the funds were *in fact* a return of capital at the time of the transfer." *Id.* at 4. The court of appeals also rejected petitioner's argument that requiring a defendant to demonstrate that a distribution was in fact intended to be a return of capital "unconstitutionally shifts the burden of proof to the defendant." *Id.* at 5-6. The court held that the government had established unreported income through proof that petitioner had diverted funds from the corporation and failed to report them. Noting the lack of evidence that the funds petitioner received "were considered, intended, or recorded on the corporate records as a return of capital at the time they were made," *id.* at 6 (quoting *Miller*, 545 F.2d at 1215), the court of appeals held that the district court had correctly required petitioner to lay a foundation before allowing him to present his return-of-capital defense to the jury. *Ibid.* The court further concluded that the district court had correctly rejected petitioner's proffer as inadequate. *Ibid.*

The court of appeals acknowledged that its approach conflicted with that of the Second Circuit, which held in *United States* v. *D'Agostino*, 145 F.3d 69, 72-73 (1998),

that a taxpayer need not show that a lawful diversion of funds was intended as a return of capital when invoking the return-of-capital defense. See Pet. App. 6 (citing *D'Agostino* and *United States* v. *Bok*, 156 F.3d 157, 162 (2d Cir. 1988)). The court noted, however, that it was "by no means certain" that petitioner would prevail even under the Second Circuit's approach. *Ibid.*[2]

Judge Thomas concurred. Pet. App. 13-14. He indicated that, if he were "writing on a clean slate," he would adopt the Second Circuit's approach in *Bok* and *D'Agostino*. *Id.* at 13. He emphasized, however, that "the outcome [in this case] would not be affected" under the Second Circuit's approach, because the diversions here "may be properly considered unlawful" and because "the record indicates that [petitioner] was not the sole shareholder of HIE, which would also likely preclude him from asserting a return [of] capital defense." *Id.* at 14.

SUMMARY OF ARGUMENT

A defendant is not entitled to present a return-of-capital defense to the jury simply by asserting that he was a shareholder who diverted funds from a corporation without earnings and profits (and that he had a stock basis at least equal to the diverted amount). For the diverted funds to be a return of capital, they must have been a distribution "with respect to [the corporation's] stock," and the question whether the diverted

---

[2] The court of appeals also rejected, *inter alia*, petitioner's attempt to renew his argument, which it had rejected on his first appeal, that the state-court judgment conclusively established that the funds he transferred to his girlfriend were the property of HIE. Pet. App. 11-12. Petitioner raised that issue in his petition for a writ of certiorari, Pet. i, 7-11, but this Court did not grant review of that question.

funds were such a distribution turns on the parties' intent, as objectively manifested by all of the facts and circumstances.

A. The text of Section 301 of the Internal Revenue Code requires that a payment to a shareholder be a distribution by the corporation "with respect to its stock" in order for the payment to be treated as a return of capital under Section 301. 26 U.S.C. 301(a) and (c). The ordinary meaning of the phrase "with respect to its stock" limits return-of-capital treatment to payments that are made to a shareholder *by reason of* his status as such. Accordingly, a diversion of funds from a corporation that lacks earnings and profits to a shareholder who has a sufficient basis in his stock to cover the diversion is not automatically a nontaxable return of capital. Rather, before a corporate payment receives the tax treatment in Section 301, the payment must meet the threshold requirement of having been a distribution "with respect to [the corporation's] stock."

Whether a corporate payment meets that requirement turns on all the facts and circumstances of the case. A payment does not qualify for treatment under Section 301 if the shareholder has received the funds in some capacity other than his capacity as shareholder, for example, as an employee, creditor, or embezzler. In the context here, where a shareholder has taken elaborate steps to hide diverted funds that he now asserts are a nontaxable return of capital, there must be some demonstration that the funds were in fact intended to be such a return before he is entitled to have the jury consider a return-of-capital defense. Just as intent is relevant to whether a payment is made in a nonshareholder capacity, so too is it relevant to whether it was made in a shareholder capacity.

B. If petitioner were correct that any diversion to a shareholder by a corporation without earnings and profits constituted a nontaxable return of capital up to the shareholder's basis, it would be an open invitation to tax fraud. Any taxpayer who also happens to be a shareholder could divert corporate assets with fraudulent intent and then, years later, when his fraud is discovered, claim that the diversion was a nontaxable return of capital. And, if he is not discovered, he can, without acknowledging any previous reduction in his stock basis, subsequently take a recorded return of capital, also tax-free. Nothing in the statute sanctions such a result.

C. Requiring a defendant to adduce evidence that a diversion was intended to be a distribution with respect to stock in order to invoke a return-of-capital defense does not create a disparity between criminal and civil tax cases. In civil tax cases, just as in criminal cases, whether corporate payments were made to a shareholder "with respect to [the corporation's] stock" depends on all of the facts and circumstances, including the intent of the corporation and the parties. What evidence is necessary to demonstrate that a payment was with respect to stock may vary with the circumstances, and a court may conclude that the purported intent of the corporation or shareholder was not consistent with the economic substance of the transaction. But that does not mean, as petitioner contends, that intent is not relevant; rather, actual intent is highly relevant.

D. Moreover, the approach of the court below does not shift the burden of proof to criminal defendants. The question at issue here is not one of burden of proof, but of the legal elements of the return-of-capital defense. The government retains at all times the burden of proving the elements of tax evasion beyond a reason-

able doubt. But once the government proves an unreported receipt of funds that derive from a likely source of income, it is incumbent on the defendant to adduce some evidence suggesting that the funds were not taxable. Here, petitioner sought to adduce evidence that the funds were a nontaxable return of capital, but he proffered no evidence on the threshold requirement of that defense, namely, that he received the diverted funds by reason of his status as a shareholder.

E. In any event, petitioner cannot prevail even under a rule that any diversion to a shareholder from a corporation without earnings and profits is automatically a return of capital up to the amount of the shareholder's basis in his stock. No court has applied such an automatic rule where, as here, the shareholder unlawfully diverted the corporate funds.

ARGUMENT

THE DIVERSION OF CORPORATE FUNDS TO A SHAREHOLDER OF A CORPORATION WITHOUT EARNINGS AND PROFITS DOES NOT AUTOMATICALLY QUALIFY AS A NONTAXABLE RETURN OF CAPITAL UP TO THE SHAREHOLDER'S STOCK BASIS

An individual can divert money or property from a corporation in which he is a shareholder in various ways, including by having the corporation pay his personal expenses, by "skimming" corporate receipts without ever recording the receipts as income by the corporation, or by simply taking corporate funds. Here, the government proved that petitioner diverted approximately $10 million from the corporation in all three of those ways. Pet. App. 3; see Pet. App. 30. Those diverted funds were not reported as income by petitioner, and petitioner's failure to report that income on his per-

sonal tax return formed the basis of the counts in the indictment charging the filing of false returns and evasion of income taxes. J.A. 10-17.

Among other defenses, petitioner sought to claim that the funds were a nontaxable return of capital under Sections 301 and 316 of the Code, and thus were not required to be included in his taxable gross income. J.A. 97-98. Petitioner proffered no evidence, however, that the diversions were in fact a return of capital. Instead, he proffered expert testimony that because he was "the controlling shareholder, the monies could be deemed a constructive dividend or return of capital to [petitioner] which may or may not be income depending on whether or not [the corporation] had earnings and profits for the years when the monies were obtained by [petitioner]." J.A. 98.

Petitioner contends (*e.g.*, Br. 8, 11) that a diversion of corporate funds to a shareholder of a corporation without earnings and profits automatically qualifies as a nontaxable return of capital up to the shareholder's stock basis, regardless of the reasons the shareholder received the funds. That assertion cannot be squared with the text of Section 301 and would sanction tax fraud. It could not, even if correct, justify setting aside the verdict in this case.

A. The Text Of Section 301(a) Requires Evidence That The Payments Were In Fact Distributions To The Taxpayer By Reason Of His Status As A Shareholder

1. Section 301(a) of the Code provides that "a distribution of property * * * made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)." 26 U.S.C. 301(a). Under Section 301(c)(2), if a corporation in fact

makes a distribution with respect to its stock and has no earnings and profits, the distribution is treated as a nontaxable return of capital up to the amount of the shareholder's adjusted basis in his stock. 26 U.S.C. 301(c)(2); see p. 4, *supra*. Thus, if a corporation without earnings and profits makes a distribution of funds with respect to its stock, and the amount of funds received by a shareholder does not exceed that shareholder's adjusted basis in his stock, the shareholder does not have to include the amount of those funds in his taxable gross income. The shareholder's basis in the stock, however, would be reduced by the amount of the distribution. 26 U.S.C. 301(c)(2).

For the return-of-capital treatment to apply, however, the corporate payment must meet the conditions of Section 301(a). See 26 U.S.C. 301(c) (stating that its terms apply "in the case of a distribution to which subsection (a) applies"). The text of Section 301(a) requires that the corporation's payment must be a "distribution * * * with respect to its stock." 26 U.S.C. 301(a). The plain meaning of that phrase limits the applicability of Section 301's tax treatment to distributions that are made to shareholders *qua* shareholders, *i.e.*, *by reason of* the recipients' status as shareholders.

As this Court has often instructed, "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses." *Crane* v. *Commissioner*, 331 U.S. 1, 6 (1947); see, *e.g.*, *Hartford Underwriters Ins. Co.* v. *Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) ("[W]hen the statute's language is plain, the sole function of the courts * * * is to enforce it according to its terms," unless "the disposition required by the text is * * * absurd.") (internal quotation marks and citation omitted). In ordinary par-

lance, the phrase "with respect to" means "with reference to," "as regards," and "insofar as concerns." *Webster's Third New International Dictionary of the English Language* 1934 (1993).[3] Those definitions all suggest more than a happenstance connection. Rather, those definitions connote an act that is taken *because* of a certain connection. Applying those ordinary meanings here, the plain text of Section 301(a) requires that the distribution of property by the corporation be made to a shareholder because of his ownership of its stock.

Consistent with its ordinary meaning, the IRS has consistently interpreted Section 301 as "not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder *in his capacity as such.*" 26 C.F.R. 1.301-1(c) (2007) (emphasis added); see 26 C.F.R. 1.301-1(c) (1955) (same). The legislative history of the Internal Revenue Code of 1954, which added the phrase "with respect to its stock" to the corporate distribution provisions, likewise supports that conclusion. See S. Rep. No. 1622, 83d Cong., 2d Sess. 231 (1954) ("Subsection (a) accordingly makes clear that section 301 has applicability only to distributions of property to shareholders in their capacity as such."). Distributions made to shareholders in other capacities do not qualify. "For example, a distribution of property to a shareholder who is a creditor of the corporation in satisfaction of his claim against the corporation is not within the scope of section 301." *Ibid.*

---

[3] See *The Random House Dictionary of the English Language* 1640 (2d ed. 1987) ("referring to; concerning"); *The Oxford American Dictionary and Language Guide* 853 (1999) ("regarding; in reference to; as concerns"); *Webster's New International Dictionary of the English Language* 2123 (2d ed. 1957) ("[a]s regards; with reference to; as to").

Thus, to fall within the tax treatment in Section 301, it is not enough, as petitioner suggests (Br. 11), to simply demonstrate that the corporation had no earnings and profits and that the taxpayer was a shareholder and had a sufficient basis in his stock to cover the amount of the diversions. Instead, before a corporate payment receives such treatment under Section 301(c), the payment must meet the threshold requirement of having been a "distribution * * * with respect to [the corporation's] stock," 26 U.S.C. 301(a), or, in other words, a payment by the corporation to the shareholder "in his capacity as such." 26 C.F.R. 1.301-1(c).

Accordingly, a taxpayer cannot maintain that any diversion of corporate funds by a shareholder must automatically be treated as a return of capital if the corporation lacks earnings and profits and the shareholder has a sufficient stock basis. *United States* v. *Miller*, 545 F.2d 1204, 1210-1214 (9th Cir. 1976), cert. denied, 430 U.S. 930 (1977). In *Miller*, the president and sole shareholder of a closely held corporation failed to record more than $850,000 in corporate receipts on the corporate books, falsely recording some of the receipts as loans from the defendant to the corporation. *Id.* at 1209. Over the same period, the corporation paid virtually all of the defendant's personal expenses ("from the mortgage on his home to his 'Book-of-the-Month' Club obligations"), and the defendant falsely characterized the expense payments as repayments of loans. *Ibid.* Following a bench trial, the district court found that the distributions were taxable as salary, and were not constructive corporate distributions under Section 301. *Id.* at 1212, 1215-1216.

In affirming that judgment, the court of appeals correctly concluded that a taxpayer is not entitled to treat

diverted corporate funds as a constructive return of capital merely because the corporation lacked earnings and profits and the shareholder had a basis in the stock at least equal to the diverted amount. *Miller*, 545 F.2d at 1211-1212, 1214. Rather, whether a corporate payment is such a distribution "depends on the factual circumstances involved in each case under consideration." *Ibid.*

A payment does not qualify as a distribution with respect to stock, for example, if the corporation pays an individual shareholder in his capacity as a debtor, creditor, employee, or vendee, or under other circumstances where the individual's status as a shareholder is incidental, such as embezzlement or misappropriation. In the context here, where a shareholder has taken elaborate steps to hide diverted funds that he now claims are a nontaxable return of capital, "there must be some demonstration on the part of the taxpayer and/or the corporation that such distributions were intended to be" a distribution to the shareholder in his capacity as such before the taxpayer can claim the benefit of the return-of-capital tax treatment. *Miller*, 545 F.2d at 1215; see *id.* at 1216 ("Such an effort to disguise an allegedly non-taxable event (which a return of capital would normally be) raises doubts as to any claim by the defendant that he considered them to be a return of capital."). By looking to objective evidence that the distribution was intended as a return of capital (or dividend or capital gain), rather than, for example, a payment of salary, repayment of a debt, or embezzlement, the standard adopted by the court of appeals ensures that Section

301(c) treatment applies only to distributions made "with respect to" the shareholder's ownership of stock.[4]

2. Tellingly, petitioner elides the phrase "with respect to its stock" in his initial discussion of Section 301's "return of capital rule." See Br. 10-13 & n.3. He ultimately acknowledges, however, that the phrase serves to "distinguish money that a taxpayer receives from a corporation in his capacity as a shareholder from money that he receives in some other capacity—as an employee, for example, or as a creditor." Br. 26; see Br. 27 (quoting 26 C.F.R. 1.301-1(c) and the legislative history discussed above). And petitioner accepts (Br. 28) that "the intent of the shareholder and the corporation may be significant in determining whether a payment constitutes salary, a loan repayment, or some other form of distribution in a nonshareholder capacity."

But intent is likewise relevant to whether a payment is a "distribution * * * with respect to [a corporation's] stock," 26 U.S.C. 301(a), and thus a payment "to the shareholder in his capacity as such." 26 C.F.R. 1.301-1(c). Petitioner offers no explanation why intent should be relevant to determining whether a payment was made by reason of a nonshareholder capacity, but not by reason of a shareholder capacity. Often, the questions are opposite sides of the same coin. For example, if a

---

[4] *Miller* stated that its rule was applicable in criminal tax cases even though it accepted that some cases had applied different constructive distribution rules in civil cases. 545 F.2d at 1212-1215. The court expressed the view that "the application of theories established in civil tax cases to problems in criminal tax cases cannot always be made." *Id.* at 1215. In the government's view, the facts-and-circumstances test articulated in *Miller* for identifying a corporate distribution with respect to its stock applies in both civil and criminal contexts. See pp. 24-31, *infra*.

payment is recorded on the corporate books as a loan to a shareholder, but there is no evidence of a contemporaneous intent to repay, that suggests that, in reality, it was not a "loan," and that it may have been a distribution with respect to the corporation's stock. See, *e.g.*, *United States* v. *Pomponio*, 429 U.S. 10, 10, 13 & n.4 (1976) (per curiam) (defendants "caused corporations they controlled to report payments to them as loans, when they knew the payments were really taxable dividends"); *Crowley* v. *Commissioner*, 962 F.2d 1077, 1080-1085 (1st Cir. 1992) ("The determination whether the parties to the transaction actually intended a loan or a dividend presents an issue of fact."). Similarly, whether payments to a shareholder-employee were compensation or dividends turns, at least in part, on whether there was compensatory intent or an intent to make dividend distributions. See, *e.g.*, *Elliotts, Inc.* v. *Commissioner*, 716 F.2d 1241, 1244-1248 (9th Cir. 1983).[5]

Nevertheless, petitioner essentially seeks (Br. 27-30) a default rule to the effect that any diversion by a shareholder of corporate funds is a distribution "with respect to [the corporation's] stock," 26 U.S.C. 301(a), "unless there is evidence to the contrary." Br. 29. But nothing in the statute supports such a rule. Instead, Congress has set forth particular predicates for the tax treatment

---

[5] The tax treatment of such funds, for both the shareholder and the corporation, depends on the nature of the payment. For example, salary is included in an individual's taxable gross income, as is embezzled money, see 26 U.S.C. 61(a); *James* v. *United States*, 366 U.S. 213, 219 (1961) (plurality opinion), whereas a bona fide loan by a corporation to a shareholder is not. See *Commissioner* v. *Tufts*, 461 U.S. 300, 307 (1983). And, although a corporation may deduct amounts that are salary (26 U.S.C. 162(a)(1); 26 C.F.R. 1.162-1(a)), or that are stolen (26 U.S.C. 165(e)), it cannot deduct distributions with respect to its stock.

provided by Sections 301 and 316, one of which is that the payment be a corporate "distribution * * * with respect to its stock." 26 U.S.C. 301(a). Unless there is evidence of a causal link to stock ownership, diversions cannot be so characterized. Moreover, petitioner omits (Br. 28-29) from his examples of evidence that would be "to the contrary" one particularly relevant way in which someone who happens to be a shareholder can receive funds in a nonshareholder capacity: embezzlement. Where, as here, a taxpayer diverts substantial funds from a corporation, "assume[s] control of the funds and then fails to report such funds as income or to make any adjustments in the corporate books to reflect a return of capital," *Miller*, 545 F.2d at 1214 n.12, there is evidence that the funds were not a distribution by the corporation "with respect to its stock," but were, for example, embezzled funds. In this context, the court of appeals was correct to require some demonstration that the distribution was "intended to be" a distribution with respect to the corporation's stock. Pet. App. 4 (citing *Miller*, 545 F.2d at 1214-1215). That is particularly true where, as here, there were efforts at concealment that would make little sense in the context of an actual nontaxabie distribution "with respect to stock."[6]

---

[6] Contrary to petitioner's contention (Br. 24-25), the requirement of such a showing is not inconsistent with the fact that current earnings and profits are determined at the close of the corporation's tax year. See 26 U.S.C. 316(a)(2). A defendant can adduce evidence of the requisite intent by showing that, at the time of the diversion, there was evidence that the transfer was intended to be a corporate distribution "with respect to [the corporation's] stock," and that, at the close of the taxable year, when the amount of current earnings and profits became known, the transferred funds were treated as a dividend, return of capital, or capital gain.

B. Congressional Purpose Would Be Thwarted If Unexplained Diverted Funds Were Automatically Treated As Distributions With Respect To Stock

Petitioner's proposed interpretation of Sections 301 and 316 would thwart congressional purpose and would encourage tax fraud. Congress sought to tax all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *James* v. *United States*, 366 U.S. 213, 219 (1961) (plurality opinion) (quoting *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)). This includes lawful and unlawful gains, regardless of whether the taxpayer has any legal right to retain the money. *Ibid.* (holding, in a criminal case, that embezzled funds are taxable); *Rutkin* v. *United States*, 343 U.S. 130, 136-137 (1952) (same as to extorted funds). In addition, Congress has established a system for the collection of the income tax that relies "largely upon the taxpayer's own disclosures." *Spies* v. *United States*, 317 U.S. 492, 495 (1943). "This system can function successfully only if those within and near taxable income keep and render true accounts." *Ibid.*

Contrary to those congressional goals, the automatic return-of-capital rule advanced by petitioner would "sanction the diversion and non-reporting of corporate and personal funds." *Miller*, 545 F.2d at 1214. A shareholder of a corporation without earnings and profits could divert corporate funds to his own use (up to the amount of his stock basis) with no risk of ever paying taxes on those gains or being found criminally liable under the tax laws. Such a rule would "permit the taxpayer to divert [corporate] funds and if not caught, to later pay out another return of capital; or if caught, to avoid conviction by raising the defense that the sums

were a return of capital and hence non-taxable." *Id.* at 1215.

Moreover, petitioner's rule would create an anomaly, whereby "[a] taxpayer who diverted funds from his close corporation when it was in the midst of financial difficulty and had no earnings and profits would be immune from punishment (to the extent of his basis in stock) for failure to report such sums as income." *Miller*, 545 F.2d at 1214. But "that very same taxpayer would be convicted if the corporation had experienced a successful year and had earnings and profits." *Ibid.* Congress could not have intended such a result.

This case illustrates how petitioner's rule would frustrate Congress's purposes. Petitioner diverted $10 million in corporate funds, and he laundered some of those funds through companies in the Kingdom of Tonga and Hong Kong. Petitioner did not report those funds as income. If petitioner's diversions had never been uncovered, he could subsequently have recorded a return-of-capital on the corporation's books and removed still more funds from the corporation tax-free. Here, of course, petitioner's diversions were discovered. Since that discovery, he alternatively has contended that the diverted funds still belonged to the corporation (Pet. App. 34-35; J.A. 174), that the funds were used for corporate purposes (J.A. 59-60, 95), that the funds "were loans" (Pet. App. 56; J.A. 95, 174), and that the funds "could" have been returns of capital (Pet. App. 4). The jury, which was instructed on petitioner's first three claims (J.A. 174-175), necessarily rejected those characterizations. If petitioner were now able to recharacterize the payments post hoc as nontaxable returns of capital, despite the lack of *any* evidence that the payments were in fact intended to be distributions to him

because of his status as a shareholder, that would sanction not only his evasion of taxes, but also encourage others to engage in similar behavior.

C. The Approach Of The Court Below Is Consistent With Civil Tax Cases

Contrary to petitioner's assertion (Br. 15-26), the approach of the court below is consistent with the application of Section 301 in civil cases. In the civil context, as in the criminal context, a disbursement of corporate funds to a shareholder is not automatically treated as a distribution "with respect to its stock." In both contexts, whether a payment to a shareholder was because of his status as a shareholder or for some other reason turns on all of the facts and circumstances, including the intent of the corporation and the shareholder.

1. Petitioner relies (Br. 11) on the approach of the Second Circuit, but that approach stems from a faulty assumption that, in civil cases, distributions of corporate funds to a shareholder are automatically treated as distributions "with respect to [the corporation's] stock." See *United States* v. *Bok*, 156 F.3d 157, 162-163 (1998); *United States* v. *D'Agostino*, 145 F.3d 69, 72-73 (1998). In *D'Agostino*, the Second Circuit held that every distribution of funds to a shareholder from a corporation without earnings or profits qualifies as a return of capital up to the shareholder's stock basis, even if the distribution was not intended as a return of capital. 145 F.3d at 72-73; see *Bok*, 156 F.3d at 162-164 (observing that "under certain circumstances monies lawfully withdrawn from a corporation by one of its shareholders may constitute a nontaxable return of capital," but holding that the defendant failed to meet his burden of coming forward with evidence of a lack of earnings and profits).

In *D'Agostino*, shareholders in a closely held corporation diverted approximately $400,000 in corporate funds to their personal use and hid the cash in kitchen drawers. The distributions were not intended as repayments of capital; the court conceded that "[i]t is entirely possible the D'Agostinos intended to evade paying taxes." 145 F.3d at 73. Nonetheless, the court held that because the corporation did not have earnings or profits, the distributions automatically qualified as nontaxable returns of capital, up to the defendants' basis in their stock. *Id.* at 72-73.[7]

The Second Circuit considers its approach "better reasoned" because, in its view, inquiring into the intent of the corporation to make a distribution with respect to stock would "place[] greater emphasis on the intent element in criminal tax evasion cases" while "minimiz[ing] the government's burden of proving a tax deficit," and would have the anomalous result of assigning the government "a higher burden of proof in a civil tax collection matter than in a criminal tax evasion prosecution." *D'Agostino*, 145 F.3d at 73. In reaching that conclusion, however, the Second Circuit misread the Tax Court's decision in *Truesdell* v. *Commissioner*, 89 T.C. 1280 (1987), and the IRS's acquiescence in that decision, 1988-2 C.B. 1 (1988), as standing for the proposition that diverted funds in civil cases are automatically treated as

---

[7] Although the defendants' stock basis did not exceed the amount that they had diverted, the Second Circuit did not treat the remaining amount as capital gain under Section 301(c)(3). Instead, the court of appeals allowed the taxpayers to treat a portion of the amount diverted as a repayment of a loan, despite the lack of any evidence that it was in fact such a repayment. *D'Agostino*, 145 F.3d at 71, 73.

distributions "with respect to [the corporation's] stock" under Section 301.[8]

Neither *Truesdell* nor the IRS's acquiescence in that decision supports such an automatic rule. In *Truesdell*, the Tax Court rejected the government's argument that diverted funds are automatically taxable as ordinary income in every case where the taxpayer exercises "dominion and control" over the funds, and that a taxpayer cannot defend on the basis that the funds were distributions with respect to stock. 89 T.C. at 1298. But the court also followed *Miller* in refusing "to apply the constructive distribution rules automatically to shareholder diversions of corporate funds." *Id.* at 1299-1300 (noting that the case was appealable to the Ninth Circuit). Having rejected the automatic rules urged by both parties, the Tax Court concluded, in its capacity as the finder of fact, that the diversions by the sole shareholder in that case were constructive dividends to the extent that the corporation had earnings and profits, concluding that "the corporation ha[d] conferred a benefit on the share-

---

[8] Both *D'Agostino* and petitioner cite the acquiescence, reflected in *Truesdell*, *supra*, action on decision, 1988-25, 1988 WL 570761 (Sept. 12, 1988) (unpublished), as a proxy for the IRS's position in all civil cases. But the action on decision expressly states that it "is not to be relied upon or otherwise cited as precedent by taxpayers." *Ibid.* Further, the Internal Revenue Service Cumulative Bulletin listing the acquiescence states that "[c]aution should be exercised in extending the application of the decision to a similar case unless the facts and circumstances are substantially the same" and that "[a]cquiescence in a decision means acceptance by the Service of the conclusion reached, and does not necessarily mean acceptance and approval of any or all of the reasons assigned by the Court for its conclusions." *Cumulative List of Announcements Relating to Decisions of the Tax Court Published in the Internal Revenue Service Bulletin from January 1, 1988 Through December 31, 1988*, 1988-2 C.B. 1.

holder *in order to* distribute available earnings and profits without expectation of repayment." *Id.* at 1295 (emphasis added); see *id.* at 1293-1295, 1300.

In its memorandum recommending acquiescence in the Tax Court's decision, the IRS stated that it would no longer seek automatic application of the "dominion and control" rule with respect to wholly owned corporations. *Truesdell, supra*, action on decision, 1988-25, 1988 WL 570761 (Sept. 12, 1988) (unpublished). But it reiterated that a diversion of corporate funds cannot qualify as a constructive distribution where "the funds were additional salary or otherwise were received *in a nonshareholder capacity*." *Ibid.* (emphasis added).

In addition to *Truesdell*, the Second Circuit based its rule on its earlier decisions in *DiZenzo* v. *Commissioner*, 348 F.2d 122 (1965), and *United States* v. *Leonard*, 524 F.2d 1076 (1975), cert. denied, 425 U.S. 958 (1976). See *D'Agostino*, 145 F.3d at 72. But the *D'Agostino* holding was not required by those cases. In *Leonard*, the court did not need to decide whether the diverted funds should automatically be treated as a return of capital, because the court recognized that "[a]cceptance of this still does Leonard no good," because he had failed to satisfy his burden of producing "sufficient evidence of an absence of earnings and profits to warrant submission to the jury" of a return-of-capital defense. 524 F.2d at 1083-1084. In *DiZenzo*, the Second Circuit held that the Tax Court had erred in ruling that the corporate distribution rules could never apply to diverted corporate funds. 348 F.2d at 125. Interpreting an earlier version of the corporate-distribution provisions, the court also concluded that "no reason appears why [the funds] cannot properly be described as 'distribution(s) made by a corporation to its sharehold-

ers,'" noting that "the government ha[d] not shown that the ordinary meaning" of that language "is inadequate in this instance." *Ibid.* (quoting 26 U.S.C. 115 (1946)). But that now-superseded statutory provision did not contain the limiting phrase "with respect to its stock," and thus is not support for the *D'Agostino* rule. Compare 26 U.S.C. 115 (1946), with 26 U.S.C. 301(a); see *DiZenzo* v. *Commissioner*, 23 T.C.M. (CCH) 677, 704 n.10 (1964) (quoting 26 U.S.C. 115 (1946)), rev'd in part, 348 F.2d 122 (2d Cir. 1965).[9]

Accordingly, in civil cases just as in criminal cases, a distribution of property must have been "made by a corporation to a shareholder with respect to its stock" in order for the payments to receive dividend/return-of-capital/capital gain treatment under Section 301. 26 U.S.C. 301(a) and (c); see 26 C.F.R. 1.301-1(c). It is thus the Second Circuit's approach, not *Miller*, that departs from the ordinary rule in civil tax cases.

2. Petitioner's reliance on the "constructive dividend" cases is similarly unavailing. Petitioner points to cases in which courts have determined that corporate benefits should be treated as dividends, despite the expressed contemporaneous intent of the corporation or the taxpayer that the payments be treated otherwise. See Br. 27-28. But those cases are consistent with the approach of the court below.

For example, in *Neonatology Associates, P.A.* v. *Commissioner*, 299 F.3d 221 (3d Cir. 2002), two profes-

---

[9] Petitioner also cites (Br. 12) *AJF Transportation Consultants, Inc.* v. *Commissioner*, 77 T.C.M. (CCH) 1244 (1999), aff'd, 213 F.3d 625 (2d Cir. 2000) (Table), and *DiLeo* v. *Commissioner*, 96 T.C. 858, 883-885 (1991), aff'd, 959 F.2d 16 (2d Cir.), cert. denied, 506 U.S. 868 (1992), but both of those Tax Court cases were appealable to the Second Circuit, and the Tax Court was following the Second Circuit's *DiZenzo* decision.

sional medical corporations had purchased special life insurance policies, with "artificially inflated premiums," under which an employee could access the excess funds paid by the corporations. *Id.* at 223-226, 228. In determining whether the amount of the excess contributions made by the corporations were constructive dividends (as the IRS claimed) or employer-deductible expenses or compensation (as the corporations claimed), the court considered all the factual circumstances, including the intent of the corporations and employees. It concluded that the contributions were "disguised dividends and not deductible expenses." *Id.* at 224; see *id.* at 231-233. In so doing, the court looked behind the form that the payments had taken, observing that the substance of the transaction was akin to a dividend, *id.* at 231-232, that it was "implausible" that the owners of the corporations had knowingly "overpaid substantially for term life insurance," and that only the owners of the corporations, and not non-owner employees, received the benefit. *Id.* at 229.

Petitioner's reliance (Br. 11, 22 n.8) on *Noble* v. *Commissioner*, 368 F.2d 439 (9th Cir. 1966), is misplaced for the same reason. Although the court stated that the intention of the parties is not "controlling" in determining whether corporate payments were dividends, *id.* at 443, it made that statement in rejecting the shareholders' contemporaneous treatment, as business expenses, of corporate payments "for painting and repairs on the family residence, travel expense, summer residence expenses and other items of a personal nature," *id.* at 441. Upon consideration of all the evidence, the court concluded that, despite the characterization on the corporate books, the corporation had distributed available

earnings and profits to the shareholders. *Id.* at 442-443.[10]

The cases cited by petitioner (Br. 27-28) thus do not support petitioner's claim that "[a]part from *Miller* and its progeny in the criminal context, courts do not define constructive dividends (or other distributions 'with respect to [a corporation's] stock') in terms of the intent of the corporation or the shareholder." Br. 27. To the contrary, those cases demonstrate that corporate labels are not controlling and that whether a payment by a corporation to a shareholder is a distribution "with respect to its stock" depends, just as in *Miller*, "on the factual circumstances involved in each case under consideration," including the intent of the corporation and the taxpayer. *Miller*, 545 F.2d at 1214.

What evidence is necessary to make that showing will vary according to the circumstances of the case. Where, for example, a corporation has recorded a transaction as a nonshareholder payment, but the evidence indicates that the economic substance of the transaction does not match that characterization, such evidence creates an inference that the transaction was in fact intended to be one in a shareholder capacity. While in such cases a transaction may ultimately be treated differently from the characterized intent of the corporation or the shareholder, it does not follow, as petitioner suggests (Br. 28), that actual intent is not important in de-

---

[10] *Magnon* v. *Commissioner*, 73 T.C. 980 (1980), upon which petitioner also relies, is similar. See *id.* at 992-997 (rejecting shareholder's claim that corporation's performance of services on his personal property constituted bona fide loans, where there was no contemporaneous intent to repay, and concluding on all the facts, including a lack of intent that the corporation benefit from the services performed, that the services were "distributions to Magnon with respect to his stock").

termining whether a corporate diversion is "with respect to [the corporation's] stock" under Section 301(a).

The "constructive dividend" cases are consistent with the well-established principle that in determining the taxability of a transaction, courts are not bound to the form of the transaction as structured by the taxpayer; rather, courts may determine the taxability of a transaction based upon the economic substance of the transaction. See, *e.g.*, *Diedrich* v. *Commissioner*, 457 U.S. 191, 197-198 (1982); *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945); *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729-731 (1929). But those cases do not suggest that form is irrelevant. This is particularly true where, as here, allowing the taxpayer to retroactively recharacterize his transaction would encourage tax fraud. Cf., *e.g.*, *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974) (taxpayer "must accept the tax consequences of his choice [of organization of his affairs], whether contemplated or not, * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not").

D. The Approach Of The Court Below Does Not Shift The Burden Of Proof

Petitioner contends (Br. 20-21) (quoting *D'Agostino*, 145 F.3d at 73) that the *Miller* approach "effectively eliminates proof of a tax deficiency as an element" of a Section 7201 violation, and thereby "reduces the prosecution's burden of proof." That assertion is incorrect.

It is well settled that the government's introduction of circumstantial evidence of unreported income "may transfer the burden of going forward to the defendant." *Leonard*, 524 F.2d at 1083; see, *e.g.*, *Bok*, 156 F.3d at 163

("[A] defendant does always bear the burden of production—under which the defendant must make an initial showing on each key element of the theory—to receive an instruction on the return of capital theory."); *Miller*, 545 F.2d at 1214 & n.12. As Judge Friendly noted in *Leonard*, 524 F.2d at 1083, that principle follows from this Court's decision in *Holland* v. *United States*, 348 U.S. 121 (1954). In *Holland*, the Court held that the government can establish a circumstantial case of criminal tax evasion by proving an increase in net worth that is not reflected in reported income, along with evidence supporting an inference that the increase is attributable to a likely source of income. *Id.* at 129-132, 137-138. "[T]he Government is not required to negate every possible source of nontaxable income, a matter peculiarly within the knowledge of the defendant." *Id.* at 138. Cf. *United States* v. *Massei*, 355 U.S. 595, 595 (1958) (per curiam) (holding that if "all possible sources of nontaxable income [were] negatived, there would be no necessity for proof of a likely source").

Here, the government amply met its burden. It produced evidence of $10 million in unexplained funds that petitioner had received and had not reported on his income tax returns. The government also adduced "proof of a likely source" of that income: namely, that he had diverted funds from the corporation. *Holland*, 348 U.S. at 137-138. That satisfies the government's burden of proving a deficiency. Having made that showing, the government was not required to "negative all the possible nontaxable sources" of petitioner's increase in income. *Holland*, 348 U.S. at 137. As the Court has recognized, "most assets derive from a taxable source, and * * * when this is not true the taxpayer is in a position to explain the discrepancy." *Id.* at 126. Thus, although

"the ultimate burden of persuasion remains with the government," *Leonard*, 524 F.2d at 1083, and "[t]he Government must still prove every element of the offense beyond a reasonable doubt," once the government presents an adequate case of unreported income, the defendant "remains quiet at his peril." *Holland*, 348 U.S. at 138-139.

Petitioner acknowledges these principles (Br. 16), and he does not affirmatively contest them. See NACDL Amicus Br. 9-10 (acknowledging that "a defendant may have the burden of going forward to establish no corporate earnings or profits"). Nor does he contend that the government had to prove that the diversion was not "with respect to [the corporation's] stock" as part of its case in this prosecution. *Holland* makes clear that it need not do so, until the defendant properly places that matter in issue. 348 U.S. at 138-139.

At bottom, the question here is not about the correct allocation of burdens of proof and production, but rather about the governing legal standard for the return-of-capital defense. The government agrees that it retains the ultimate burden of proving all the elements of its charges beyond a reasonable doubt. But a defendant must adduce sufficient evidence on each element of the return-of-capital defense to warrant submission of that defense to the jury. In the government's view, that defense has three elements: (1) that the diverted funds were intended to be a distribution "with respect to [the corporation's] stock," (2) that the corporation lacked earnings and profits during the relevant period, and (3) that the defendant had a basis in his stock at least equal to the amount of the diverted funds. Because petitioner proffered no evidence that the corporate diversions here were intended to be "with respect to [the cor-

poration's] stock," he did not sustain his burden of production, and the government was therefore not required to disprove his return-of-capital defense.[11]

E. Petitioner's Convictions Should Be Affirmed Even If A Lack Of Earnings And Profits, And A Sufficient Stock Basis, Are The Only Elements Of A Return-Of-Capital Defense

1. Even if the Court adopts the Second Circuit's approach, petitioner's convictions should be affirmed. The Second Circuit has qualified its "'no earnings and profits, no income' rule" by maintaining that the rule does not apply in cases "of *unlawful* diversion, such as embezzlement, theft, a violation of corporate law, or an attempt to defraud third party creditors." *D'Agostino*, 145 F.3d at 73. It repeated that note of caution in *Bok*, explaining that *D'Agostino* had "made clear" that the rule had no application in cases of unlawful diversion. 156 F.3d at 162 n.1 (citing *D'Agostino*, 145 F.3d at 73). That exception has deep roots in the civil tax cases on which the *D'Agostino* court relied. See Pet. App. 14 (Thomas, J., concurring); *Truesdell*, 89 T.C. at 1298 (emphasizing that "petitioner's diversions of income * * * were not per se unlawful" and did not appear to be "stolen, embezzled, or diverted in fraud of creditors"); *DiZenzo*, 348 F.2d at 125 (emphasizing that "[w]e are not here dealing with sums stolen or embezzled by a taxpayer" and that "[t]here has been no suggestion that the

[11] Although petitioner's proffer is insufficient on its face with respect to the other two elements as well, the government did not raise that issue in its opposition to the petition for a writ of certiorari. Nor did the government present the argument in the courts below, except when it argued in opposition to the petition for rehearing in the court of appeals that petitioner's proffer made no assertion that he had a sufficient stock basis to cover the amount of the diverted funds. See Opp. to Petition for Reh'g 10 (filed Feb. 6, 2007).

diversions in this case were improper as a matter of corporate law"). It also reflects the common sense notion that the concealment that is the hallmark of such efforts would make little sense in the context of *nontaxable* distributions. See *Miller*, 545 F.2d at 1216.

In this case, the diversion of corporate funds to petitioner was unlawful. See Br. in Opp. 13-18. First, petitioner was not the sole shareholder of the corporation; a trust for the benefit of petitioner's son also holds stock in the corporation. J.A. 82-83, 86-88, 133. Although petitioner introduced minutes from corporate meetings in 1990 and 1991 purporting to grant him broad authority to use corporate funds, an expert witness for the government testified at trial that those documents had been falsified. 3 Tr. 144-145, 153-155, 157, 159-160, 164. By unilaterally diverting corporate funds to himself and his girlfriend, in excess of his authority, petitioner acted to the detriment of the other shareholder and in breach of his fiduciary duties. See *D'Agostino*, 145 F.3d at 73 (indicating that the "no earnings and profits, no income" rule has no application where the diversion of corporate funds was "a violation of corporate law"); *DiZenzo*, 348 F.2d at 125 (same).[12]

Second, petitioner's pleadings in the state-court action suggest that he diverted corporate funds to his girlfriend for the purpose of preventing his wife from obtaining the portion of the corporation's assets to which she was entitled in their divorce. Pet. App. 14 (Thomas, J., concurring); see *id.* at 31-32, 34-35. Such diversions "may be properly considered unlawful." *Id.* at 14 (Thomas, J., concurring); see *D'Agostino*, 145 F.3d at 73

[12] The absence of any similar disbursements to the other shareholder also suggests that the diverted funds were not distributed to petitioner as a shareholder.

(indicating that the "no earnings and profits, no income" rule would not apply where corporate funds were diverted in "an attempt to defraud third party creditors"); *Truesdell*, 89 T.C. at 1298 (same).

2. Petitioner argues (Br. 30-34) that the relevant statutes do not admit of any exception for the unlawful diversion of corporate funds. On this view, a shareholder may steal or embezzle corporate funds but still automatically be entitled to treat the diversions for tax purposes as if they were "to a shareholder with respect to [the corporation's] stock" in any subsequent prosecution for tax evasion or civil case concerning a tax deficiency. That again exposes the flaw inherent in petitioner's argument: he ignores the "with respect to its stock" threshold in Section 301(a), claiming once again that "[t]he characterization of a diversion for tax purposes turns solely on the factors" identified in Section 301(c), namely, "the amount of earnings and profits, the shareholder's basis in the stock, and the size of the distribution." Br. 31. As noted, the "with respect to its stock" language provides a textual basis for concluding that concealed and embezzled funds were not distributed to a shareholder qua shareholder (as opposed to qua embezzler).[13]

Petitioner also argues that a remand for a retrial would be necessary on this point, on the ground that the

---

[13] Contrary to petitioner's suggestion (Br. 33-34), *Drybrough* v. *Commissioner*, 238 F.2d 735 (6th Cir. 1956), does not stand for the proposition that unlawful funds are automatically entitled to the tax treatment under Section 301. That decision not only interprets the previous version of the corporate distribution statute, which did not contain the current "with respect to its stock" language, see pp. 27-28, *supra*, it also rejected the claim that the defendants had embezzled the funds. See *Drybrough*, 238 F.2d at 738.

jury did not find unlawfulness. Although the jury was not expressly instructed to find unlawfulness, a third trial is not warranted. The theory of the government's case was that petitioner had unlawfully diverted the funds from the corporation for his own personal benefit and that the funds were taxable on that basis. C.A. E.R. 815-820 (closing argument). Petitioner countered with his defenses that the funds were not taxable because they were corporate funds, or corporate advances, or loans, and the jury was instructed on those defenses. J.A. 173-175. The jury's verdict necessarily rejected those defenses and accepted the government's theory of the case. The only rational basis for the jury's judgment was a conclusion that petitioner unlawfully diverted the funds; no other lawful basis had any evidentiary support in the record.[14]

---

[14] As petitioner expressly acknowledges (Br. 29), neither party contended that the $10 million was salary. No other lawful basis for the payment was suggested beyond the theories the jury rejected.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

PAUL D. CLEMENT
Solicitor General

RICHARD T. MORRISON
Acting Assistant Attorney General

MICHAEL R. DREEBEN
Deputy Solicitor General

DEANNE E. MAYNARD
Assistant to the Solicitor General

ALAN HECHTKOPF
KAREN QUESNEL
S. ROBERT LYONS
Attorneys

DECEMBER 2007

APPENDIX

1. 26 U.S.C. 301 provides:

Distributions of property

(a) In general

Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) Amount distributed

(1) General rule

For purposes of this section, the amount of any distribution shall be the amount of money received, plus the fair market value of the other property received.

(2) Reduction for liabilities

The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by—

(A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) Determination of fair market value

For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) Amount taxable

In the case of a distribution to which subsection (a) applies—

(1) Amount constituting dividend

That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis

That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis

(A) In general

Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) Distributions out of increase in value accrued before March 1, 1913

That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

(d) Basis

The basis of property received in a distribution to which subsection (a) applies shall be the fair market value of such property.

(e) Special rule for certain distributions received by 20 percent corporate shareholder

(1) In general

Except to the extent otherwise provided in regulations, solely for purposes of determining the taxable income of any 20 percent corporate shareholder (and its adjusted basis in the stock of the distributing corporation), section 312 shall be applied with respect to the distributing corporation as if it did not contain subsections (k) and (n) thereof.

(2) 20 percent corporate shareholder

For purposes of this subsection, the term "20 percent corporate shareholder" means, with respect to any distribution, any corporation which owns (directly or through the application of section 318)—

(A) stock in the corporation making the distribution possessing at least 20 percent of the total combined voting power of all classes of stock entitled to vote, or

(B) at least 20 percent of the total value of all stock of the distributing corporation (except nonvoting stock which is limited and preferred as to dividends),

but only if, but for this subsection, the distributee corporation would be entitled to a deduction under section 243, 244, or 245 with respect to such distribution.

(3) Application of section 312(n)(7) not affected

The reference in paragraph (1) to subsection (n) of section 312 shall be treated as not including a reference to paragraph (7) of such subsection.

(4) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

(f) Special rules

(1) For distributions in redemption of stock, see section 302.

(2) For distributions in complete liquidation, see part II (sec. 331 and following).

(3) For distributions in corporate organizations and reorganizations, see part III (sec. 351 and following).

2. 26 U.S.C. 316 provides:

Dividend defined

(a) General rule

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

(b) Special rules

(1) Certain insurance company dividends

The definition in subsection (a) shall not apply to the term "dividend" as used in subchapter L in any case where the reference is to dividends of insurance companies paid to policyholders as such.

(2) Distributions by personal holding companies

(A) In the case of a corporation which—

(i) under the law applicable to the taxable year in which the distribution is made, is a personal holding company (as defined in section 542), or

(ii) for the taxable year in respect of which the distribution is made under section 563(b) (relat-

ing to dividends paid after the close of the taxable year), or section 547 (relating to deficiency dividends), or the corresponding provisions of prior law, is a personal holding company under the law applicable to such taxable year,

the term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) made by the corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 without regard to distributions under this paragraph) for such year.

(B) For purposes of subparagraph (A), the term "distribution of property" includes a distribution in complete liquidation occurring within 24 months after the adoption of a plan of liquidation, but—

(i) only to the extent of the amounts distributed to distributees other than corporate shareholders, and

(ii) only to the extent that the corporation designates such amounts as a dividend distribution and duly notifies such distributees of such designation, under regulations prescribed by the Secretary, but

(iii) not in excess of the sum of such distributees' allocable share of the undistributed personal holding company income for such year, computed without regard to this subparagraph or section 562(b).

(3) Deficiency dividend distributions by a regulated investment company or real estate investment trust

The term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) which constitutes a "deficiency dividend" as defined in section 860(f).

3. 26 U.S.C. 317 provides:

Other definitions

(a) Property

For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) Redemption of stock

For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

4. 26 U.S.C. 7201 provides:

Attempt to evade or defeat tax

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction

thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

5. 26 U.S.C. 7206 provides:

Fraud and false statements

Any person who—

(1) Declaration under penalties of perjury

Willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter; or

(2) Aid or assistance

Willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document; or

(3) Fraudulent bonds, permits, and entries

Simulates or falsely or fraudulently executes or signs any bond, permit, entry, or other document required by the provisions of the internal revenue laws, or by any regulation made in pursuance thereof, or procures the same to be falsely or fraudulently exe-

cuted, or advises, aids in, or connives at such execution thereof; or

(4) Removal or concealment with intent to defraud

Removes, deposits, or conceals, or is concerned in removing, depositing, or concealing, any goods or commodities for or in respect whereof any tax is or shall be imposed, or any property upon which levy is authorized by section 6331, with intent to evade or defeat the assessment or collection of any tax imposed by this title; or

(5) Compromises and closing agreements

In connection with any compromise under section 7122, or offer of such compromise, or in connection with any closing agreement under section 7121, or offer to enter into any such agreement, willfully—

(A) Concealment of property

Conceals from any officer or employee of the United States any property belonging to the estate of a taxpayer or other person liable in respect of the tax, or

(B) Withholding, falsifying, and destroying records

Receives, withholds, destroys, mutilates, or falsifies any book, document, or record, or makes any false statement, relating to the estate or financial condition of the taxpayer or other person liable in respect of the tax;

shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the

case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.